DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0228
Sales/Use Tax
For the Tax Periods: 1995 through 1997

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ISSUES

I. Sales/Use Tax—Utility Purchases

Authority: IC 6-2.5-4-5(c)(3), IC 6-2.5-5-5.1;
Mynsberge v. Department of State Revenue, 716 N.E.2d 629 (Ind. Tax 1999)

Taxpayer protests proposed assessments of use tax on its utility purchases.

II. Sales/Use Tax—Foundations

Authority: IC 6-2.5-5-3(b);
45 IAC 2.2-5-8(c)

Taxpayer protests proposed assessments of use tax on its purchase of equipment foundations.

III. Sales/Use Tax—Forklifts

Authority: IC 6-2.5-5-3;
45 IAC 2.2-5-8;
Indianapolis Fruit Co. v. Department of State Revenue, 691 N.E.2d 1379 (Ind. Tax 1998)

Taxpayer protests the Department's calculation of the pro rata exemptions afforded to taxpayer's forklifts.

IV. Sales/Use Tax—Refuse Chip Conveyor System

Authority: IC 6-2.5-5-3;
45 IAC 2.2-5-8(h)

Taxpayer protests proposed assessments of use tax on its purchase of a Refuse Chip Conveyor System (RCCS).

V. Sales/Use Tax—Pallet Washer

Authority: IC 6-2.5-5-3;
45 IAC 2.2-5-8(h)

Taxpayer protests proposed assessments of use tax on its purchase of a Pallet Washer.

VI. Sales/Use Tax—Lot Control System

Authority: IC 6-2.5-5-3;
45 IAC 2.2-5-8

Taxpayer protests proposed assessments of use tax on purchases of Lot Control Systems.

VII. Sales/Use Tax—"Factory Link" Equipment

Authority: IC 6-2.5-5-3(b)

Taxpayer protests proposed assessments of use tax on its purchases of "Factory Link" Equipment.

VIII. Negligence Penalty

Authority: IC 6-8.1-10-2(d);
45 IAC 15-11-2(b);
45 IAC 15-11-2(c)

Taxpayer protests assessment of the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation with its base of operations located in a state other than Indiana. Taxpayer's Indiana business activity consists of an engine assembly plant. As a result of a sales and use tax audit for tax periods 1994 through 1997, assessments of use tax were proposed. Taxpayer now protests these assessments.

I. Sales/Use Tax—Utility Purchases

DISCUSSION

Taxpayer protests Audit's assessment of use tax on taxpayer's purchase of certain utilities. According to taxpayer, the utility purchases in question qualify for either the exclusion (pro rata or predominate usage) provided by IC 6-2.5-4-5(c)(3) or the pro rata consumption exemption provided by IC 6-2.5-5-5.1.

The exclusion statute (IC 6-2.5-4-5(c)(3)) requires the utilities to have been "used by the purchaser for the excepted uses listed . . . ." The exemption statute (IC 6-2.5-5-5.1) affords an exemption for utilities consumed "if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing . . . ." Consequently, the purchaser of the utilities must also be the consumer in order for any exclusion or exemption to apply.

Taxpayer explains the current scenario:

> Until 1991, [Taxpayer] directly owned and operated the foundry and engine plants located [in] Indiana (the ["Indiana Plant"]). During 1991, Taxpayer contemplated selling its foundry operation. To facilitate the potential sale, [Taxpayer] created a separate entity, ["Subsidiary"], and transferred the ownership of the foundry operation to Subsidiary. The sale of the foundry operation never occurred and Subsidiary continues to be a wholly owned subsidiary of Taxpayer.
>
> The metering of the utilities at the [Indiana Plant] did not change when Subsidiary was created. In fact, such an endeavor would be cost-prohibitive for Subsidiary and unnecessary given the existing metering allows for an accurate, straight-forward method for separating utility cost by entity.

Taxpayer depends upon a prior utility study to establish its qualification for the predominate use exclusion. This prior utility study was completed before Taxpayer and Subsidiary became separate entities. Because of this fundamental change of circumstances—and the conspicuous absence of an appropriate utility study—Audit, in computing the exempt use for Taxpayer, proposed assessments on all of Taxpayer's utility purchases. Taxpayer was instructed that in order to receive credit for the portion used in production for the audit period, Taxpayer needed to conduct new utility studies for each meter.

In response to Audit's comments and conclusions, Taxpayer conducted a new utility study ("Updated Utility Study") documenting the exempt usage of its utility purchases for the period following the separation of the Subsidiary's foundry activities from Taxpayer's engine assembly operations.

In Mynsberge v. Department of State Revenue, 716 N.E.2d 629 (Ind. Tax 1999), the Indiana Tax Court found that "the [utility] exclusion [of IC 6-2.5-4-5(c)] is predicated on the [P]urchaser of the utility services and commodities consuming those services and commodities." Id. at 634. The explicit language of the exemption statute (IC 6-2.5-5-5.1) requires the purchaser of utility services to have consumed the utilities in the prescribed manner to qualify for the exemption. As Taxpayer did not consume a portion of the utilities purchased, Taxpayer may not claim such consumption—and the concomitant exemptions or exclusions—for itself. That is, Taxpayer may not include the exempt usage attributable to Subsidiary in calculating its own exempt usage percentages.

FINDING

Taxpayer's protest is respectfully denied. Audit will review the recently submitted Updated Utility Study to modify the exempt use percentages properly attributable to Taxpayer.

II. Sales/Use Tax—Foundations

DISCUSSION

Audit has assessed use tax on taxpayer's purchase of foundations constructed specifically to support its production equipment. Taxpayer argues these foundations qualify for the manufacturing equipment exemptions provided by IC 6-2.5-5-3(b) and 45 IAC 2.2-5-8(c). Specifically, IC 6-2.5-5-3(b) provides:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for the direct use in the direct production, manufacture, fabrication . . . of other tangible personal property.

In support of exempt treatment, taxpayer reasons:

> The manufacturing equipment could not operate without the support of the attached foundations. These specially designed foundations become a part of the machinery, and are required for proper support and stabilization of the machinery. In fact, the cost of these foundations are capitalized by [taxpayer] in its fixed asset system as machinery and equipment . . . . A much smaller foundation would be required if it was only supporting the real estate improvements.

Taxpayer is correct. Foundations constructed specifically to support exempt manufacturing equipment—exempt pursuant to IC 6-2.5-5-3(b)—are also exempt as equipment acquired "for the direct used in the direct production . . . of other tangible personal property." This exemption, with regard to foundations, is construed narrowly. Foundations not constructed specifically for exempt equipment—that is not necessary and integral to the operation of the exempt equipment—will be characterized as improvements to real estate. Such improvements are not within the purview of IC 6-2.5-5-3(b).

FINDING

Taxpayer's protest is sustained.

III. Sales/Use Tax—Forklifts

DISCUSSION

Taxpayer and Audit disagree as to the percentage of exempt use properly attributable to taxpayer's forklifts. Taxpayer explains this disagreement:

> Pursuant to the audit, the Auditor recalculated Taxpayer's exempt usage percentage related to the forklift trucks and reduced the refund claim proportionate to the Auditor's exemption recalculation, which excluded use of the forklifts by [an affiliated corporation]. This exempt use recalculation was erroneous since the exempt used claimed by the refund appropriately calculated the correct exempt use of the forklifts by both companies.

Audit responds with the following reasoning:

> The forklift analysis submitted [by taxpayer] as part of the Claim [for Refund] computed [a] taxable usage of 43%. The taxpayer's study includes forklifts for the taxpayer and [the affiliated corporation's] adjacent plant. In prior years, the [affiliated corporation] was a division of [taxpayer] and this method [of computing exempt usage] was appropriate. As they are now separate corporations, forklifts of the [affiliated corporation] should not be included in the study.

The exemption referred to by both Audit and taxpayer is based on the language of IC 6-2.5-5-3(b), which states:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly…of other tangible personal property.

Audit interprets the cited language as requiring the *purchaser* of the equipment to *use* the equipment in the prescribed manner to qualify for the exemption. Taxpayer contends that as long as the equipment is used in an exempt manner, the identity of the user is irrelevant. Taxpayer misreads this exemption statute.

The regulation interpreting IC 6-2.5-5-3 requires the purchaser of the property—not a third party—to use the purchased property in an exempt manner. As the prologue to 45 IAC 2.2-5-8 informs:

> Sec. 8. (a) In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation *[45 IAC 2.2]* extends only to manufacturing machinery, tools, and equipment **directly used by the purchaser** in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced. (Emphasis added.)

And finally, the Department notes that the agricultural exemptions (IC 6-2.5-5-1 and IC 6-2.5-5-2), as well as the other industrial exemptions (IC 6-2.5-5-4, IC 6-2.5-5-5.1, IC 6-2.5-5-6), all require the purchaser of the tangible personal property to use the property in a prescribed manner

in order to qualify for exempt treatment. The Indiana Tax Court in Indianapolis Fruit Co. v. Department of State Revenue, 691 N.E.2d 1379 (Ind. Tax 1998) echoed this principle when it stated:

> Indianapolis Fruit contends that it is entitled to the exemptions contained in sections 6-2.5- 5-1 to -3 for its banana and tomato ripening equipment and the protective clothing worn by its employees at the Garden Cut facility. Sections 6-2.5-5-1 and -2 exempt tangible personal property used in agricultural production. **Section 6-2.5-5-3 is a more general provision, and is often referred to as the equipment exemption.** It exempts manufacturing machinery, tools, and equipment used to produce "other tangible personal property." Ind. Code Ann. § 6-2.5-5-3(b) (West Supp. 1997).
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> **All three exemption provisions require that the taxpayer engage in production before qualifying for the exemption.** See Mechanics Laundry & Supply, Inc. v. Department of State Revenue, 650 N.E.2d 1223, 1228-29 (Ind. Tax Ct. 1995) (construing section 6-2.5-5-3 as requiring production); Department of State Revenue v. American Dairy, Inc., 338 N.E.2d 698, 700 (Ind. App. 1975) (construing predecessor statute to sections 6-2.5-5-1 and -2 as requiring production). (Emphasis added.)

FINDING

Taxpayer's protest is respectfully denied.

IV. Sales/Use Tax—Refuse Chip Conveyor System

DISCUSSION

Audit has assessed use tax on taxpayer's purchase of a Refuse Conveyor System ("RCCS"). Taxpayer explains the utility of this system:

> One of the many steps in the . . . engine manufacturing process is the "broaching operation." A broach is a tapered or serrated tool used to place metal into a flat surface. When the broach planes the surface of the cylinder head, the RCCS catches the small pieces of metal, turnings and shavings ("chips") that the planing creates. The RCCS operates in the front end of the head line. The RCCS immediately removes the chips so that the chips do not clog up the equipment and cause damage. The base of the manufacturing machinery contains openings that allow chips to fall onto the chip conveyor and move away from the equipment. This operation is continuous throughout the production cycle and must be contrasted to periodic or pre- or post production cleaning or maintenance.

Given the function of the RCCS within the context of the aforementioned production process, taxpayer argues that this equipment is "essential and integral" to the process of producing engines. See IC 6-2.5-5-3 and 45 IAC 2.2-5-8.

Taxpayer also presents an alternate theory in support of exempt treatment for its RCCS. As taxpayer explains:

> The chips collected by the RCCS are a manufactured by-product which is collected, gathered, packaged, and sold as scrap by [taxpayer]. Once the chip is manufactured by the broaching process, the conveyor transports it [the chips] to the packaging department where the chips are placed in a gondola. The gondola serves as the package for [taxpayer's customer]. The RCCS, thus, provides transportation between production stages in regard to the manufacture of this by-product.

Taxpayer manufactures engines. One step in taxpayer's manufacturing process—the broaching operation—creates unwanted residue of small metal chips. Uncorralled, these chips pose a hazard to both taxpayer's manufactured product and manufacturing equipment. Taxpayer, therefore, purchased equipment (RCCS) to assist in the removal (via conveyor) of these chips from production areas. According to taxpayer, these removal activities are "continuous throughout the production cycle . . . ."

These metal chips represent an unwanted byproduct from taxpayer's manufacturing operations. Although the removal of such byproducts is a necessary ancillary activity to that of manufacture, such removal does not appear, functionally, to be "essential and integral" to taxpayer's integrated production process. Rather, the removal of the metal chips is best characterized as a nonexempt post-production maintenance activity. 45 IAC 2.2-5-8(h).

And finally, the fact that these "chips"—a byproduct of taxpayer's manufacturing process—have economic value does not make taxpayer, for purposes of Indiana sales/use tax exemptions, a producer, manufacturer, fabricator, assembler, extractor, minor, processor, refiner, or finisher of "chips." Rather, despite the economic consequences of doing so, the gathering, collecting, and disposing of byproduct from a manufacturing activity remain routine nonexempt post-production maintenance activities. 45 IAC 2.2-5-8(h).

FINDING

Taxpayer's protest is respectfully denied.

V. Sales/Use Tax—Pallet Washer

DISCUSSION

Audit has proposed assessments of use tax on taxpayer's purchase of a Pallet Washer. Taxpayer opines:

> The Pallet Washer is used to facilitate the flow of the production line by removing dirt, shavings, loctite and RTW sealant from the pallets, which, if left undisturbed, will cause engines [taxpayer's product] to become out of location during the

> assembly process. The presence of such contaminants during the production process will interfere with the attainment of the exacting specifications required for engine production and will cause engine failure.

Taxpayer, therefore, reasons that its "purchase of the Pallet Washer [should be exempt] from Indiana sales and use tax pursuant to Ind. Code § 6-2.5-5-3 since it constitutes manufacturing machinery and equipment acquired for the direct use in the direct production…of other tangible personal property."

Even assuming *arguendo* that taxpayer's pallets qualify for a manufacturing exemption as "production equipment," the cleaning of such equipment—regardless of necessity—does not qualify for similar treatment. The cleaning and maintenance of production equipment are legitimate nonexempt pre and post-production activities. As 45 IAC 2.2-5-8(h) instructs:

> Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

Or conversely, as Audit succinctly stated, "Pallet washers do not have a direct effect on the article being produced." See IC 6-2.5-5-3.

FINDING

Taxpayer's protest is respectfully denied.

VI. Sales/Use Tax—Lot Control System

DISCUSSION

Audit has proposed assessments of use tax on taxpayer's purchase of "Lot Control Systems." According to taxpayer:

> These [Lot Control] systems input data regarding production and identify batches by serial number. The system allows taxpayers to recall batches going through the process whenever a problem is discovered. Lot control systems are an integral part of manufacturing equipment which is used during the production process and which has an immediate effect on the article being produced. Such systems are an essential and integral part of the production process, since only non-defective products are acceptable for sale.

Audit characterized the function of taxpayer's Lot Control Systems as one of inventory management—a nonexempt use.

The Department disagrees with taxpayer's conclusions. From the narrative presented it would be impossible for the Department to conclude that taxpayer's Lot Tracking System has been acquired "for direct use in the direct production, manufacture, fabrication, assembly…of other

tangible personal property. IC 6-2.5-5-3(b). The tracking or monitoring of inventory, for whatever purposes, is not "essential and integral" to the production of the inventory being monitored. Such usage (inventory management) is best characterized as a nonexempt post-production activity. 45 IAC 2.2-5-8.

FINDING

Taxpayer's protest is respectfully denied.

VII. Sales/Use Tax—"Factory Link" Equipment

DISCUSSION

Audit has proposed assessments of use tax on taxpayer's purchase of certain equipment. Taxpayer explains:

> The Auditor has proposed to assess [use] tax on Taxpayer's purchase of certain production equipment from FactoryLink, Deemstop and Englewood (together referred to as "FactoryLink"). The purchase of FactoryLink equipment is exempt from sales and use tax pursuant to Ind. Code § 6-2.5-5-3(b)…. FactoryLink equipment is necessary and essential to production when used in its Tool Management and Gage Management function modes since FactoryLink equipment will take the balance of the manufacturing machine out of cycle when tool wear reaches its maximum allowable amount. *See* 45 IAC 2.2-5-8(c)(5).

Audit characterized taxpayer's FactoryLink system as non-production, nonexempt "supervisory control and data acquisition [equipment]." Audit described the utility of the FactoryLink equipment in the following manner:

> FactoryLink shuts down machinery when predetermined and routine maintenance is due. FactoryLink tracks the number of operations performed, but does not monitor the production process.

From the facts presented, it appears the FactoryLink equipment is used exclusively to monitor production equipment in order to determine when routine maintenance should be performed. Such use is neither essential nor integral to taxpayer's integrated production process. Taxpayer's use is more a function of maintenance rather than production. The equipment, therefore, does not qualify for the exemption provided by IC 6-2.5-5-3(b).

FINDING

Taxpayer's protest is respectfully denied.

VIII. Negligence Penalty

DISCUSSION

Taxpayer has requested that the Department exercise its statutory discretion to abate the ten-percent negligence penalty assessed under authority of IC 6-8.1-10-2.1(a). The penalty was assessed against the taxpayer's additional sales and use tax liabilities.

IC 6-8.1-10-2.1(d) provides potential relief from imposition of the penalty. The statute states that if a person – subject to the negligence penalty imposed under IC 6-8.1-10-2.1(a) – can demonstrate that the failure to file a tax return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay a deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use the "reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer." Negligence results from a "taxpayer's carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations."

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax was due to "reasonable cause." 45 IAC 15-11-2(c). Taxpayer may establish "reasonable cause" by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." Id. In determining whether "reasonable cause" exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

The Department finds that the taxpayer has established "reasonable cause" sufficient to warrant abating the ten-percent negligence penalty.

FINDING

Taxpayer's protest is sustained.

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